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# FRBSF WEEKLY LETTER

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## Inflation in China

Visiting China today is perhaps not unlike visiting a bustling town in America's Old West: the railroad has arrived, opening up the town's products to vast markets in the East. Farms, ranches, and lumber yards are expanding rapidly. New construction is everywhere. Prosperity and boundless optimism are in the air. But then someone calls: "Fire! Fire!" Already, flames are leaping into the sky and spreading. The whole town is now panicked by the conflagration. It seems that the townspeople have been preoccupied with construction, and have not taken time to organize fire brigades and acquire fire-fighting equipment.

In this little allegory, the railroad is the economic reform since 1978 which has brought rapid economic growth and a rising standard of living to China; the fire is an accelerating inflation that threatens much of what economic reform has brought to date.

The subject of China's economic reform and its current inflation concerns not only the livelihood of that nation's more than one billion inhabitants, but also the stability and prosperity of a region of substantial political and economic interest to the United States and the rest of the Western world. Moreover, given China's lead in economic reform, its success or failure in controlling inflation will have a significant impact on the future of economic reform in other socialist nations, including that of the Soviet Union.

### **Sweet fruits of economic reform**

In December 1978, China's leaders adopted a program of economic reform to move the nation away from a Soviet-type planned economy toward one that would rely more on market mechanisms within a socialist framework. The tension arising from these two apparently conflicting goals—market mechanism and socialist economy—has presented policymakers with serious challenges in uncharted territory.

The reform started in the rural area where 80 percent of the population resides. The communes were replaced by a "production responsibility" system, under which individual households leased land for fifteen years in return for a commitment to pay taxes and fulfill planned production quotas. After meeting these obligations, the rural households have been free to produce whatever they choose and sell the above-quota output on the "free market" at prices which, though still regulated, could be considerably higher than the official prices.

This simple but sweeping reform, plus significant increases in the official purchase prices of farm products, released a large reservoir of productive initiative and energy formerly dammed up in the communes. Farm output increased so rapidly that for a few years until consumption caught up, granaries were bulging with surplus grains. The nation turned from a major cotton importer to a sizable cotton exporter—to the chagrin of U.S. cotton growers. Even more remarkably, rural industrial development took off, turning out a wide range of consumer products, construction materials, and industrial components and parts. Unplanned and unregulated by the state, rural industries soon became the fastest growing sector of the economy. In 1987, for the first time, the value of rural industrial production exceeded that of farm production.

Encouraged by the success of rural reform, the leaders in 1984 launched a program of urban reform. The new program granted substantial autonomy to urban enterprises in managing their own businesses, drastically reduced the scope of mandatory planning, and opened the national economy to foreign trade and foreign investment. The enterprises that still fall under mandatory planning are required to produce and deliver to the state in quantities and at prices specified by the planning authorities. However, their above-quota output as well as the output of enterprises outside mandatory planning now can be sold at prices that are negotiated between buyers and sellers, within ranges set by the authorities.

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The results of economic reform have been astounding. Since 1980, real national income and industrial and agricultural output have all grown at about 10 percent compound annual rates. Farmers' per capita real income has doubled, and that of urban dwellers has increased by 43 percent. Gone are the long lines of people holding ration coupons in front of food stores. Housing shortages—though still acute, especially in urban areas—are being relieved by the construction of high-rise apartments in cities and attractive single-family two-story buildings in the countryside. Besides bicycles, city streets are now jammed with automobiles, mostly imported. Refrigerators, color televisions, and washing machines, once considered luxuries, are now available and accessible to the general public. In conversations with people on the street and in their homes, it is hard to find a single person who is unenthusiastic about these fruits of economic reform.

## **One bitter fruit**

Yet the record of China's economic reform has not been unblemished. Reform has exacerbated several existing economic and social problems, the most serious of which is inflation.

Reform unleashed an enormous expansion of market demand at a rate far outstripping that of output. Rural reform has boosted rural income. Urban reform has enabled enterprise managers to give workers indiscriminate bonuses and undertake lavish investment projects.

Fueling all this has been unrestrained bank lending to enterprises, resulting in annual currency growth rates averaging 29 percent in 1984 through 1987 and 36 percent in the first half of 1988, compared to an annual average of three percent in 1961 through 1978. Official data report retail-price inflation rates of nine percent in 1985, six percent in 1986, seven percent in 1987, and 13 percent in the first half of this year. But the actual inflation rates for urban consumers are believed to have been about double these official rates.

Actually, inflation is nothing new in China. The hyper-inflation of 1948–49 was a major factor contributing to the downfall of the Nationalist government and the Communists' rise to power in 1949. One of the crowning achievements of

the new government was its success in bringing inflation quickly under control in the early 1950s and keeping the price level stable until 1980, except for a brief lapse in the early 1960s. During most of the period, price stability was maintained by freezing all prices and wages, and reinforced by tight control over the money supply and the use of ration coupons to limit consumption. Thus, for about a quarter of a century, the population was accustomed to receiving a fixed wage plus a basket of payments in kind (such as housing, health care, education, etc.). This assured a certain standard of living, with no fear of price increases.

But frozen prices were the very antithesis of the market mechanism. And so, from the beginning, the reformers recognized that letting market forces determine prices was an essential part of economic reform. However, steps in that direction have been hesitant and limited, for fear of their impact on consumer prices. Urban consumer prices have been kept artificially low through government subsidies. These subsidies swelled enormously after 1979, when, as a part of rural reform, farm product prices were raised, but not urban food prices. Industrial prices over time became so out of line with production costs that enterprise profits and losses could no longer serve as indicators of market demand and supply, nor of efficiency of management. Underpricing of energy and transport in particular resulted in vast waste in their consumption and serious under-investment in their production.

Partial reform brought about a complicated three-tiered price structure: "free" prices, "negotiated" prices, and fixed prices—all regulated by the authorities. This price structure aggravated price distortions and gave rise to widespread hidden side-payments and corruption. And yet this price structure was not even adequate to control the rise in overall prices.

Prolonged inflation imposes severe hardships because China's per capita income still is low, wages in many sectors remain rigid, and labor has little job mobility. Rural households can cope with inflation much better than urban residents can, because rural households have become entrepreneurs in largely unregulated business pursuits. Urban workers, in contrast, depend on wages and bonuses. Wages have risen minimally,

and bonuses have been distributed very unevenly among sectors and enterprises. Government workers, school teachers, and retired persons have been hit especially hard. Moreover, urban workers are tied to their present employment and cannot shift jobs without the permission of their employers. It requires no great imagination to sense the tremendous frustration and resentment of those who are caught in this bind.

### **Policy debate and action**

In the midst of this increasingly explosive situation, policymakers earlier this year were engaged in an intense debate over the future direction of economic reform. One school advocated easing credit and investment restraints in order to sustain rapid economic growth and create a favorable environment for dismantling all remaining price controls. The resultant inflation they regarded as a necessary evil, but acceptable with concomitant wage increases. The other school advocated freeing up all prices only after inflation was brought under control. This latter approach called for drastic curtailment of investment and credit growth and acceptance of a slower output growth for the sake of bringing inflation under control. The pro-growth proponents regarded this view as unnecessarily timid and obstructive to economic progress.

For a time, it seemed that the pro-growth advocates were gaining the upper hand. During the first half of this year, bank credit growth accelerated markedly, and in June a senior official of the central bank publicly acknowledged a policy of credit ease. As inflation accelerated, the government announced on August 18 a decision to lift price and wage controls over a five-year period.

However, while the policymakers debated, consumers took to the streets this summer, rushing to withdraw savings from banks to purchase goods ahead of further price increases. Rumors of higher grain prices led to frenzied buying of rice in one city. Expectations of a 40 percent price rise caused shoppers in another city to snap up sixty thousand pairs of shoes from one store in four

days. A department store in a third city reported the sale of electric appliances in July at two hundred times the normal level. By late August, these scattered stirrings had swollen to an avalanche. Long lines had formed at banks to withdraw funds, and a senior central bank official had to deny rumors of banks limiting fund withdrawals.

In the face of this rapidly spreading crisis, the new five-year price-wage reform program was abruptly suspended. Premier Li Peng announced on August 30 that there would be no more price adjustments during the rest of the year, that measures would be taken to insure a lower inflation rate next year, and that capital investment and bank lending henceforth would be severely curtailed. In addition, banks were instructed to institute new "value-preserving" deposits, tying interest rates on time deposits of three years or longer to the cost-of-living index. Less than two weeks later, a new "temporary" regulation was promulgated to limit all cash transactions in the economy to wage payments and farm-product purchases, and to require all other payments to be made through bank accounts. The regulation is apparently intended to restore banks' role as watchdogs over all spending by enterprises and government agencies and to revert to the old method of spending control that had proven effective prior to reform.

This crisis has revealed a fundamental flaw in China's economic reform. The reform has released market forces without instituting effective macroeconomic policies for restraining public and private spending, such as used in most market economies. In the short run, the authorities in China have no choice but to re-impose direct controls. In the longer run, preservation of the fruits of economic reform and further progress in reforming China's economy will depend on effective monetary, financial, and fiscal policies for macroeconomic stabilization that so far have been absent in the Chinese economy.

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